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By Michael S. Lewis

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Lewis discusses how tax practitioners representing commercialized marijuana businesses must be familiar with federal and state tax law, criminal law, and banking law to respond to the needs of their clients, particularly after the July 2015 Ninth Circuit decision in Olive v. Commissioner.

A. Introduction

Commercialized marijuana has a substantial and underreported federalism problem, one that reaches well beyond the confines of federal criminal prosecution and into the complexities of federal tax law. On July 9 the Ninth Circuit in Olive v. Commissioner concluded that a business selling medical marijuana to patients was prohibited by section 280E from deducting ordinary and necessary business expenses under section 162(a). Section 280E forecloses a taxpayer engaged in a trade or business from taking any deduction or credit if the “trade or business . . . consists of trafficking in controlled substances” prohibited by state or federal law.2

The decision applied to a “medical marijuana” business in California. The court’s reasoning leaves little doubt that the ruling will apply with equal if not greater force to businesses in states such as Washington, Oregon, and Alaska, all within the Ninth Circuit, where the sale of marijuana for recreational use is now legal under state law.3 Moreover, because U.S. Supreme Court precedent so strongly favors federal supremacy in this area, it is unlikely that states could take action to put these taxpayers on equal footing with other businesses.4

Federal congressional intervention is therefore necessary to correct the imbalance this ruling creates both within the industry and between marijuana businesses and other businesses that are entitled to deductions. This need is reflected in two bills introduced this spring and pending before Congress.5

In the absence of congressional action, the Ninth Circuit’s decision, coupled with case law from the Tax Court, raises substantial questions regarding how businesses that sell marijuana must account for and manage their costs of doing business. This uncertainty extends to how they respond to federal audits, particularly given the difficulties in accounting for costs and expenses caused by federal banking law.6

3Colorado also legalized marijuana for nonmedical purposes, but it is under the jurisdiction of the Tenth Circuit Court of Appeals. See Governing, “State Marijuana Laws Map,” (mapping states based on regulation of marijuana); see also Todd Garvey et al., “Marijuana: Medical and Retail — Selected Legal Issues,” Congressional Research Service report R43435 (Apr. 8, 2015) (describing the current landscape of marijuana laws in the United States); see also Map of the Ninth Circuit, United States Courts for the Ninth Circuit.

4See Gonzales v. Raich, 545 U.S. 1 (2005) (finding commerce clause gave Congress the authority to prohibit local cultivation and use of marijuana despite state laws legalizing medical marijuana); and United States v. Oakland Cannabis Buyer’s Coop., 532 U.S. 483 (2001) (“medical necessity is not a defense to manufacturing and distributing marijuana”); see also Roche, supra note 1, at 439 (discussing U.S. Supreme Court cases reaffirming federal supremacy to criminalize commercialized medical marijuana in states where this commercial activity is allowed under state law).

5Senate and House bills were introduced on April 16 to exclude businesses consisting of “marijuana sales conducted in compliance with State law.” See Small Business Tax Equity Act of 2015, S. 987; see also H.R. 1855 (2015).

Further, because the developing law in this area has focused on commercialized marijuana, substantial questions remain unaddressed regarding the role of the IRS in reviewing the operations of some related types of businesses, such as pain and addiction treatment clinics, in which medical providers dispense controlled substances under highly regulated conditions.\(^7\)

Increasing public concern that these clinics serve as a gateway to serious drug addiction may cause the IRS to treat these businesses as operating in a manner prohibited by federal and state law, subjecting them to the section 280E exclusion.\(^8\)

To respond to these issues on behalf of clients, it is now necessary to have a broad familiarity with federal tax law and its administration, the federal Controlled Substances Act, and federal criminal procedure.

**B. Olive v. Commissioner: A Case History**

*Olive v. Commissioner* was brought to the Tax Court by the owner of a San Francisco medical marijuana dispensary.\(^9\) Martin Olive, the petitioner, was the sole proprietor of the Vapor Room, whose principal (and legal) business was the retail sale of medical marijuana under the California Compassionate Use Act of 1996.\(^10\) The voters of California approved this act as a ballot initiative “to ensure that ‘seriously ill Californians’ (recipients) can obtain and use marijuana if physicians recommend marijuana as beneficial to recipients’ health.”\(^11\)

In the aftermath of the passage of this act, it has been estimated that between 500 and 1,000 medical marijuana dispensaries legally operate in Los Angeles alone, with commentators estimating that dispensaries “far outnumber” Starbucks coffee shops.\(^12\)

The IRS audited the Vapor Room for tax years 2004 and 2005. At the conclusion of the audit, the IRS found that Olive was barred from deducting the cost of goods sold (COGS) and ordinary business expenses.\(^13\) The IRS foreclosed the COGS deduction because Olive failed to substantiate them. The IRS disallowed the ordinary business expenses deductions because it concluded that they fell under section 280E.\(^14\)

The Tax Court disposed of the issues separately.

Regarding the taxpayer’s ability to substantiate COGS, the court had little sympathy for Olive’s claims that the marijuana industry does not favor the retention of receipts for purchases and sales.\(^15\) The court further noted that “neither Congress nor the Commissioner has prescribed a rule stating that a medical marijuana dispensary may meet that substantiation requirement merely by maintaining a self-prepared ledger listing the amounts and general categories of expenditures.”\(^16\)

In an important passage, the court ruled that Olive “chose to transact the Vapor Room’s business primarily in cash” and “chose not to keep supporting documentation for the Vapor Room’s expenditures . . . at his own peril.”\(^17\)

These observations were reflected in the court’s COGS adjustment and the imposition of an accuracy-related penalty.\(^18\)

The court separately concluded that Olive was not entitled to deduct any business expenses under section 280E, which provides\(^19\):

> No deduction or credit shall be allowed for any amount paid or incurred during the taxable year in carrying on any trade or business if such trade or business (or the activities which comprise such trade or business) consists of trafficking in controlled substances (within the meaning of schedule I and II of the

\(^{13}\)See *Olive*, 139 T.C. at 28.  
\(^{14}\)Id.  
\(^{15}\)Id. at 33 (“We disagree with petitioner that the ledgers standing alone are sufficient substantiation.”).  
\(^{16}\)Id. at 33-34.  
\(^{17}\)Id. at 36 (footnote omitted).  
\(^{18}\)Id. at 43. The Tax Court’s method of relying on the testimony of an expert witness to assist in directing its ultimate conclusion regarding the COGS adjustment while deeming that expert witness’s testimony “unreliable in that he was not sufficiently independent of petitioner and his cause” may warrant a separate article on the Tax Court’s approach to evaluating and relying on expert testimony. See id. at 35.  
\(^{19}\)Id. at 38-39. The court differentiated COGS from section 162(a) deductions on the ground that COGS deductions are subtracted from gross receipts in determining a taxpayer’s gross income and are therefore deductions “for convenience” outside the scope of section 162(a). Id. at n.2.
Controlled Substances Act) which is prohibited by Federal law or the law of any State in which such trade or business is conducted.\textsuperscript{20}

The court held that the sale of marijuana by a dispensary constituted trafficking under this provision, reaffirming a holding in a prior decision discussed below.\textsuperscript{21}

Although the court imposed accuracy-related penalties for the COGS issue, it did not do so with regard to the section 280E deductions because of the issue’s novelty at the time Olive filed the returns.\textsuperscript{22}

The court distinguished the case from an earlier Tax Court decision, Californians Helping to Alleviate Medical Problems Inc. v. Commissioner (CHAMP).\textsuperscript{23} In that case, the court concluded that the term “trafficking” includes supplying medical marijuana even to the terminally ill under the good faith auspices of state law.\textsuperscript{24} However, the court apportioned section 162(a) deductions between what it concluded were two separate businesses, a caregiving business and a dispensary business, and applied the section 280E exclusion only to the business devoted to selling medical marijuana.\textsuperscript{25} In making its decision, the court underscored that CHAMP’s caregiving services were “extensive” and were the business’s “primary purpose.”\textsuperscript{26}

In Olive, the court rejected arguments by Olive that he ran distinct businesses and concluded that the Vapor Room was solely in the business of dispensing marijuana.\textsuperscript{27} The court distinguished the businesses by stating that CHAMP was driven by a “caregiving mission,” while the other stressed “the sale and consumption (through vaporization) of marijuana.”\textsuperscript{28}

Olive appealed the Tax Court’s holding on the application of section 280E to the Ninth Circuit. This appeal triggered the first ruling from an Article III federal appellate court on the tax treatment of legalized marijuana businesses under section 280E in the aftermath of successful legalization efforts in more than 20 states.

The Ninth Circuit began its analysis by asking if the Vapor Room was a trade or business under the statute, focusing on whether the taxpayer engaged in the activity “with the dominant hope and intent of realizing a profit.”\textsuperscript{29} This test arose out of a Supreme Court decision evaluating the tax-exempt status of a section 501(c)(3) entity.\textsuperscript{30}

The Ninth Circuit concluded that the Vapor Room’s operations met the trade or business standard because its only income-generating activity was the sale of marijuana.\textsuperscript{31} The Vapor Room’s other activities, which included the provision of vaporizers, food and drink, yoga, games, movies, and counseling, in the court’s view, were free and so did not generate income.\textsuperscript{32} The court took pains to emphasize that its decision turned on the fact that “the income-generating activities” of the Vapor Room “consisted solely of trafficking in medical marijuana.”\textsuperscript{33}

The court also rejected Olive’s argument that section 280E should not apply to marijuana dispensaries because the statute was enacted before the legalization of marijuana by many states. The court reasoned that its decision does not prohibit these businesses, although it may make the businesses “more costly” to operate.\textsuperscript{34} The court did not explore whether its decision will make business so costly that specific forms of these businesses will cease to exist.

On August 10, after Olive, the Tax Court issued another decision in which it applied section 280E to the operations of a medical marijuana business: Beck v. Commissioner.\textsuperscript{35} The case involved a California medical marijuana dispensary that was raided by

\textsuperscript{20}Section 280E.
\textsuperscript{21}Olive, 139 T.C. at 38 (citing Californians Helping to Alleviate Medical Problems Inc. v. Commissioner, 128 T.C. 173, 182-183 (2007)).
\textsuperscript{22}Olive, 139 T.C. at 44.
\textsuperscript{23}Id. at 39-40. CHAMP has been described as the “seminal” case regarding section 280E. ILM 201504011.
\textsuperscript{24}CHAMP, 139 T.C. at 182-183 (“We define and apply the gerund ‘trafficking’ by reference to the verb ‘traffic’, which as relevant herein denotes ‘to engage in commercial activity: buy and sell regularly.’ Webster’s Third New International Dictionary 2423 (2002).”).
\textsuperscript{25}See id. at 185 (“we allocate to petitioner’s caregiving services 18/25 of the expenses for salaries, wages, payroll taxes, employee benefits, employee development training, meals and entertainment, and parking tolls (18 of petitioner’s 25 employees did not work directly in petitioner’s provision of medical marijuana)”).
\textsuperscript{26}Id. at 174-175.
\textsuperscript{27}See Olive, 139 T.C. at 40 (stating that “the differences between the operations are almost too numerous to list” but noting that the dispensary in CHAMP “was operated exclusively for charitable, education and scientific purposes and its income was slightly less than its expenses”).
\textsuperscript{28}See id. at 40.
\textsuperscript{29}See Olive, supra note 1, slip op. at 5 (citations omitted).
\textsuperscript{30}See id. at 5 (citing, inter alia, United States v. American Bar Endowment, 477 U.S. 105, 110 n.1 (1986)).
\textsuperscript{31}See id. at 6.
\textsuperscript{32}See id.
\textsuperscript{33}See id. (emphasis in original).
\textsuperscript{34}See id. at 8-9.
\textsuperscript{35}T.C. Memo. 2015-149, slip op. at 1 (2015).
the Drug Enforcement Administration. The business kept track of its cash transactions by z-tape generated through a cash register. However, it shredded all but a single year’s worth of those records and did not retain the receipt.37

The business kept track of its inventory through a system of “tub sheets,” which included details of how and when specific tubs of marijuana in inventory were acquired.38 For unknown reasons, the business intentionally destroyed those sheets.39

The court reaffirmed its previous rulings and the decisions of the Ninth Circuit in concluding that the petitioner could not deduct its expenses under section 280E.40 Perhaps more importantly, the court concluded that the business’s failure to substantiate its COGS, occasioned by its destruction of records, precluded the business from obtaining relief from the IRS adjustment.41 The destruction of inventory records was the primary reason the court decided to affirm the accuracy-related penalties.42

C. Immediate Implications of Olive

1. Application to nonmedical marijuana businesses. An obvious but important point to make about Olive is that its interpretation of section 280E will apply with equal if not greater force in states that have also legalized marijuana for nonmedical, commercialized sale. Colorado and Washington have enacted legislation authorizing the retail and personal growth, sale, and possession of marijuana.43 Alaska and Oregon have enacted similar retail marijuana laws.44 One commentator has predicted that California is entering the “golden age of commercialized marijuana.”45

Section 280E draws no distinction among the myriad types of marijuana businesses now legal under these state laws. Indeed, the Ninth Circuit exhibited very little sympathy for the substantial changes in state policy on marijuana in recent years.46 The court stated:

Application of the statute does not depend on the illegality of marijuana sales under state law; the only question Congress allows us to ask is whether marijuana is a controlled substance “prohibited under federal law.” I.R.C. section 280E. If Congress now thinks that the policy embodied in section 280E is unwise as applied to medical marijuana sold in conformance with state law, it can change the statute. We may not.47

Two bills pending before Congress seek to amend section 280E by excluding from its ambit any trade or business that “consists of marijuana sales conducted in compliance with State law.”48 The bills are advertised by the marijuana industry as an attempt to correct a substantial imbalance in tax treatment that harms the legalized marijuana industry generally.49

2. The Ninth Circuit’s reliance on familiar guidelines may signal a future trend in the development of section 280E law. The Ninth Circuit’s decision imposes two limiting factors upon the statute’s scope but leaves substantial room for argument regarding the types of marijuana operations that are subject to the statute.

The decision may be read as limited to those enterprises in which the “dominant hope and intent” is to “realize profit.”50 The holding applied to the “income-generating activities” of a business engaged “solely” in “trafficking in medical marijuana,” a standard that may not necessarily apply to businesses that have a broader purpose or additional, separate purposes.51

The Ninth Circuit’s framework bears a resemblance to federal law governing section 501(c)(3) tax-exempt entities, and the court cited case law applying to these entities. The imposition of the “profit motive” test and the “sole income-generating” test draw from the law on section 501(c)(3) standards.52

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36See id. at 8-9.
37Id. at 7.
38Id. at 6.
39Id. at 14.
40Id. at 15-16.
41Id. at 17.
42Id. at 20 (stating that “petitioner intentionally destroyed most of the inventory and sales records related . . . to his dispensary”).
43See Garvey et al., supra note 3, at n.49 (collecting statutes).
44See id. at n.59.
46See Olive, supra note 1 (“That Congress might not have imagined what some states would do in future years has no bearing on our analysis. It is common for statutes to apply to new situations.”).
47Id.
48See Small Business Tax Equity Act, supra note 5.
50See Olive, supra note 1, at 5.
51See id.
52See, e.g., Amend16Robertwiegard v. Commissioner, T.C. Memo. 2005-30 (describing four-part test for determining section 501(c)(3) tax-exempt status of entity as including whether entity is organized exclusively for a tax exempt purpose and whether private shareholder benefits from earnings of the entity); see also LTR 201215010 (whether primary purpose of an (Footnote continued on next page.)
The decision may portend the imposition of further standards by the federal appellate courts as they begin to draw upon familiar tax law concepts to provide the government and taxpayers with guidance on the tax treatment of marijuana businesses. For instance, businesses such as the one profiled in CHAMP, whose dominant mission is charitable, may offer sound arguments that Olive does not apply so broadly to their operations.53

Indeed, the current legal landscape suggests that enterprises with multiple care-related components stand the best chance of falling outside the reach of the Ninth Circuit’s definition of trade or business under section 280E. Hospice and long-term care facilities are among the enterprises that seem to have the strongest claims that their operations do not meet this definition, relieving these facilities, at least in part, of one regulatory barrier.54

D. Cost Accounting Post-Olive

1. Cost accounting will play a central role in federal audits post-Olive. Many new commercialized marijuana businesses may not be able to avoid the reach of section 280E in the same manner as hospice and long-term care centers. Because the Tax Court has ruled that section 280E does not exclude convenience deductions for COGS, many commercialized marijuana businesses may seek to remediate their tax liability by characterizing expenses as COGS.55

As one commentator has noted, the current environment reverses incentives for marijuana businesses by encouraging them to capitalize costs that they would otherwise seek to immediately deduct as expenses if not for the section 280E exclusion.56

Anticipating this response, in January 2015 the IRS published guidance that spells out the source and history of the tension between section 280E and other federal provisions such as section 471, governing inventory accounting, and section 263A, containing uniform capitalization rules governing cost accounting.57

The guidance clarifies that a commercialized marijuana entity may capitalize its costs just as other businesses would according to the type of business it engages in:

Thus, a marijuana reseller using an inventory method would have capitalized the invoice price of the marijuana purchased, less trade or other discounts, plus transportation or other necessary charges incurred in acquiring possession of the marijuana. Similarly, a marijuana producer using an inventory method would have capitalized direct material costs (marijuana seeds or plants), direct labor costs (e.g., planting; cultivating; harvesting; sorting), Category 1 indirect costs (reg. section 1.471-11(c)(2)(i)), and possibly Category 3 indirect costs (reg. section 1.471-11(c)(2)(iii)).58

Thus, IRS guidance explains that by virtue of uniform capitalization provisions, some expenses that might be subject to section 162(a) — and therefore the exclusion under section 280E — may nevertheless be deducted as COGS under section 263A.

A substantial portion of future disputes between taxpayers and the government will likely reside in this area of the Internal Revenue Code and will turn on whether taxpayers properly characterize costs as COGS and capitalized costs to clearly reflect income through an appropriate method of accounting.59

53See Wood, supra note 49 (“So the IRS says it is policing the line between the costs that are part of selling the drugs and others. Sure, deduct wages, rents, and repair expenses attributable to production activities. They are part of the cost of goods sold. But don’t deduct wages, rents, or repair expenses attributable to general business activities or marketing activities that are not part of cost of goods sold.”); see also Roche, supra note 1, at 460 (“It seems likely that some portion of the expenses described in Deductions could be allocated to inventory operations under the full absorption and UNICAP rules” (footnote omitted).)

54See Wood, supra note 49 (“The trouble started in 1982, when Congress enacted section 280E. It prohibits deductions, but not for cost of goods sold.”); see also Roche, supra note 1, at 443 (describing the legislative drafting history behind this distinction and its grounding in the constitutional requirement that an income tax be based on “income” as opposed to gross receipts).

55See Wood, supra note 49 (“The trouble started in 1982, when Congress enacted section 280E. It prohibits deductions, but not for cost of goods sold.”); see also Roche, supra note 1, at 443 (describing the legislative drafting history behind this distinction and its grounding in the constitutional requirement that an income tax be based on “income” as opposed to gross receipts).
As the law in this area develops further, businesses that grow and sell marijuana and can deduct costs that would otherwise be excluded as expenses under section 280E may have some tax advantages vis-à-vis businesses that are resellers. This may result in a distortion of the market as marijuana businesses move away from the vertical integration model that dominated its early history.60

Because growing marijuana and reselling marijuana are each illegal under federal criminal law, the different tax treatment for the two activities cannot be explained by official public policy. Any advantage for one over the other is simply fortuitous and would provide a further basis for leveling the playing field through measures such as those pending before Congress, which would exempt from section 280E marijuana businesses operating legally under state law.

Importantly, on July 31 the IRS clarified at least one substantial, although relatively uncontroversial, area of demarcation. In a memorandum on the federal tax treatment of Washington state’s excise tax on the sale of commercialized marijuana, the IRS concluded that the state’s excise tax is a “cost of the acquired property” under section 164(a) and so, like other COGS deductions, it is not subject to the prohibitions of section 280E.61 Businesses can therefore confidently deduct this state tax without concern that it will serve as a basis for an adjustment to federal tax liability in audits.

2. The Tax Court’s de facto substantiation ruling adds complexity to the industry’s banking quandaries. Even as the IRS recognizes the legitimacy of COGS deductions for commercialized marijuana businesses, federal banking regulations render the practicalities of tracking costs difficult. The Tax Court’s holding in Olive regarding COGS, which was not reviewed by the Ninth Circuit, complicates the process even further.

While outwardly refusing to adopt rules for taxpayers who seek to substantiate COGS, the Tax Court’s decision established a de facto standard that will likely drive the resolution of disputes in this area.

The Tax Court ruled that the ledgers in Olive were not sufficient to substantiate the taxpayer’s COGS under the applicable regulations.62 The Tax Court noted multiple deficiencies that led it to find the ledgers inadequate, including that the ledgers were not “independently prepared.” The Tax Court also noted that they failed to:

- specifically identify marijuana vendors;
- reflect any marijuana that was received or given away; and
- reflect expenditures contemporaneously or accurately.

These deficiencies will likely be used as the guideposts for substantiation in future disputes over COGS. All of the deficiencies could be remedied if the industry were granted entry to the banking system. Businesses could forgo reliance on cash transactions, implement checking registers or other cost-tracking programs, and track expenses as other businesses would.

Federal law creates substantial financial and legal incentives for banks to refuse to do business with the commercialized marijuana industry.63 Among other things, banks must report on each transaction conducted with a marijuana business by filing a suspicious activity report (SAR). The failure to do so carries criminal penalties.

Federal banking law, including the requirement that banks maintain anti-money-laundering programs, substantially raises the transaction costs and risks of doing business with the marijuana industry. These disincentives have caused most banks to avoid working with this industry altogether, notwithstanding efforts by the Department of Justice to provide clearer guidance.64

The marijuana industry recently tried to engage in self-help by creating its own banking infrastructure, but these efforts were stymied by the Federal Reserve, which refused to accredit a credit union in Colorado established to serve the state’s rapidly growing legalized marijuana industry.65

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60Cf. John Schroyer, “Colorado’s Emerging Wholesale Marijuana Market: Q&A With Cannabase CEO Jennifer Beck,” Marijuana Business Daily, Oct. 1, 2014 (describing industry shift away from a “vertical integration” business model in which businesses grow, sell, and bring to market marijuana in one enterprise); see also Left, supra note 54, at 534 (“If a marijuana seller is vertically integrated, growing the marijuana she sells, then opportunities to shift expenses to COGS are multiplied, because cultivation costs are properly classified as cost of goods sold.”).

61See ILM 201531016.

62Olive, 139 T.C. 19, 33.

63See Garvey et al., supra note 3, at 24; see also Jacob Sullum, “Marijuana Money Is Still a Pot of Trouble for Banks,” Forbes, Sept. 18, 2014 (describing substantial disincentives for banks to do business with the legalized marijuana industry); but see Danielle Douglas, “Obama Administration Clears Banks to Accept Funds From Legal Marijuana Dealers,” The Washington Post, Feb. 14, 2014 (describing efforts by the federal government to make banking easier for legalized marijuana businesses).

64See Ryan J. Reilly and Matt Ferner, “Feds Move to Fix Pot Shops’ Banking Problems,” Huffington Post, Feb. 17, 2014 (“Bank of America’s policy, for example, has been to not accept any marijuana businesses as customers, and it’s unclear if the guidance proposed is enough to change that.”); but see Ferner, “Some Banks Are Working With Marijuana Businesses, But They Remain Wary,” Huffington Post, Apr. 13, 2015.

The Tax Court jurisprudence in this context therefore puts marijuana businesses in one more Catch-22. It imposes unrealistic substantiation requirements, has upheld penalties for failing to meet those requirements, and does so while federal bank regulations make the traditional methods of substantiation difficult to achieve.66 It is fair to criticize the Tax Court for stating that the taxpayer in Olive “consciously chose to transact...business primarily in cash...at his own peril” without acknowledging that the banking infrastructure does not permit the taxpayer to do business in any other fashion.67

The IRS’s failure to provide additional guidance to taxpayers regarding these substantial issues, even after confirming that taxpayers may take COGS deductions, will result in additional disputes regarding the extent and manner to which marijuana businesses track their COGS.68 Enacting the Marijuana Business Access to Banking Act of 2015, a bill introduced to provide marijuana businesses with greater access to banking services, may help remedy these issues by encouraging banks to do business with the marijuana industry.69

However, this act leaves in place many other administrative barriers for banks that make doing business with the marijuana industry costly, such as substantial reporting requirements. It also fails to immunize banks or their employees from prosecu-

cation.70 Thus, even if reform efforts prove successful, taxpayers may continue to lack access to banking and thereby have difficulties substantiating their COGS.

However, what the Tax Court did clarify in its first post-Olive decision, Beck, is that a taxpayer that destroys the very minimal type of records that may be relied upon to substantiate its COGS will receive the least amount of sympathy. Acting like a criminal and destroying records will almost certainly result in a denial of COGS deductions, as well as the imposition of accuracy-related penalties.

E. Implications for Other Dispensaries

Problems arising out of section 280E extend beyond the commercialized marijuana industry. While Olive and CHAMP focused on the application of section 280E to marijuana businesses, another complicated and as of yet unaddressed application of section 280E is how it relates to pain-care and addiction treatment clinics. These businesses dispense Schedule II controlled substances such as oxycodone and methadone and would be subject to the section 280E exclusion if they are found to “traffick” these substances in a manner “prohibited by Federal law or the law of any State in which such trade or business is conducted.”71

Indeed, unlike with marijuana sellers, with dispensaries of Schedule II controlled substances, examiners would have to wade into a complex array of state and federal laws and regulations governing the manner and means by which these substances are dispensed.72 Reports suggest that this is a significant risk for many of those businesses.

In my law firm’s home state of New Hampshire, for instance, those clinics have received negative attention that could lead to tighter legal restrictions.73 At least one newspaper has reported that

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66One commentator recently suggested that the Ninth Circuit’s decision “meant that in the absence of careful records, it is possible to rely on an estimate of approximate cost-of-goods sold deductions.” Paul Jones, “Tax Practitioners’ Complicated Marijuana Work,” State Tax Notes, Aug. 10, 2015, p. 524. This account does not accurately reflect the Ninth Circuit’s decision, which did not directly review the Tax Court’s ruling on the COGS issue. It also does not acknowledge that the underlying Tax Court decision in Olive applied an extremely unfavorable method to calculate the approximation and imposed a substantial understatement penalty on the taxpayer with regard to the issue. See Olive, 139 T.C. at 35-36.

67Id. at 34; see also Julie Andersen Hill, “Banks, Marijuana and Federalism,” 65 Case W. Res. L. Rev. 597, 600 (2014) (“Without access to banking services, marijuana businesses must conduct transactions in cash and spend an inordinate amount of time and resources on cash management.”).

68One could easily imagine this issue taking center stage in any audit resulting in the assessment of a civil fraud penalty, in which litigation over adequate record keeping as one badge of fraud may take on new significance. See Molinar v. Commissioner, T.C. Memo. 1997-455, at 3-5. Moreover, the failure to establish official guidelines for substantiation deprives the taxpayer of access to burden-shifting remedies available to other businesses in litigation with the IRS. Section 7491(a)(2)(B) (maintenance of adequate records a prerequisite to burden shifting in litigation with IRS).


72Section 812(b)(2)(B) (defining Schedule II drugs as follows: “The drug or other substance has a currently accepted medical use in treatment in the United States or a currently accepted medical use with severe restrictions.”); see also David Kroll, “New Rules for Hydrocodone: What You Should Know,” Forbes, Aug. 22, 2014 (reporting new restrictions on entities dispensing certain Schedule II controlled substances).

addiction treatment clinics serially fail to comply with state regulations nationwide. These reports are not unique to New Hampshire. These clinics are facing new attention from regulators following reports detailing the extent to which prescription pain medicine has become the true gateway drug to heroin addiction. The federal government could use IRS audits as a new way to increase compliance with federal and state laws regarding prescription medicine. Section 280E would therefore require examining agents to wade into complex questions regarding whether an entity is trafficking in Schedule II controlled substances in compliance with state and federal law. Tax professionals would have to be prepared to respond to the questions these inquiries would generate.

F. Conclusion

The current state and federal conflict over controlled substances, including marijuana and prescription narcotics, has given rise to several new and substantial issues inside the arena of tax administration. To respond to the legal needs of clients operating in these industries, practitioners must have a broad understanding of federal tax law, federal and state criminal law, and state and federal healthcare law. Also, given the ever-evolving and complex nature of these areas, practitioners must also be able to assess the risks taxpayers face as these laws change.

This is not an incidental conflict. It represents a collision of the public policy and laws of many states against the tax regulations and collection and enforcement powers of the federal government. As Chief Justice Marshall remarked in an early decision on our federalism: “The power to tax includes the power to destroy.” How the taxation dynamic plays out between state and federal governments stands to become one of the more compelling legal storylines as the fast-growing industry of commercialized marijuana develops.


See, e.g., Drug Enforcement Administration release, “Four Conspirators Arrested for Operating ‘Pill Mills’” (Jan. 15, 2013) (partnership between DEA and IRS gave rise to arrest of operators of pain clinics in Atlanta).

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SUBMISSIONS TO TAX NOTES

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77 See, e.g., Drug Enforcement Administration release, “Four Conspirators Arrested for Operating ‘Pill Mills’” (Jan. 15, 2013) (partnership between DEA and IRS gave rise to arrest of operators of pain clinics in Atlanta).

78 McCulloch v. Maryland, 17 U.S. 316 (1819).